

THE GREAT DEPRESSION OF FINLAND 1990-1993: causes and consequences

Jaakko Kiander

Labour Institute for Economic
Research

CONTENTS

- Causes – background
- The crisis
- Consequences
- Role of economic policy
- Banking crisis
- Recovery
- Reflections on the current crisis

Background of the crisis: financial market deregulation

- Until the 1980s the Finnish banking sector and international capital flows heavily regulated – low risks, no credit losses
- Financial deregulation in the 1980s, following international pattern
- After gates were opened, a flow of foreign credit increased rapidly domestic liquidity 1986-89
- Credit expansion fuelled an investment boom and asset price bubble in 1987-90

Favourable fundamentals justified optimism

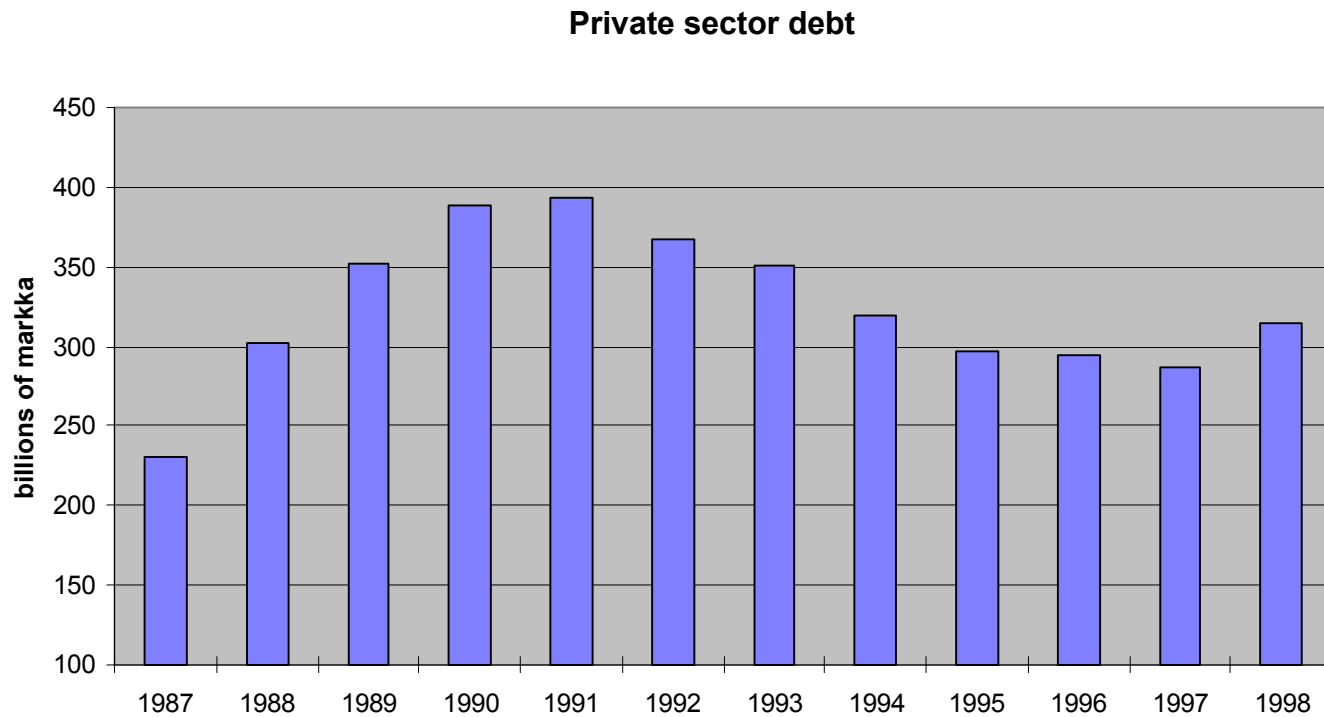
- Exports were supported by improved terms-of-trade and by rapid European growth 1986-1989
- Finland seemed a lucrative place to invest
- The policy of fixed exchange rates helped to maintain investor confidence and created an illusion of low exchange rate risk in foreign currency borrowing

Strong growth led quickly to overheating and indebtedness

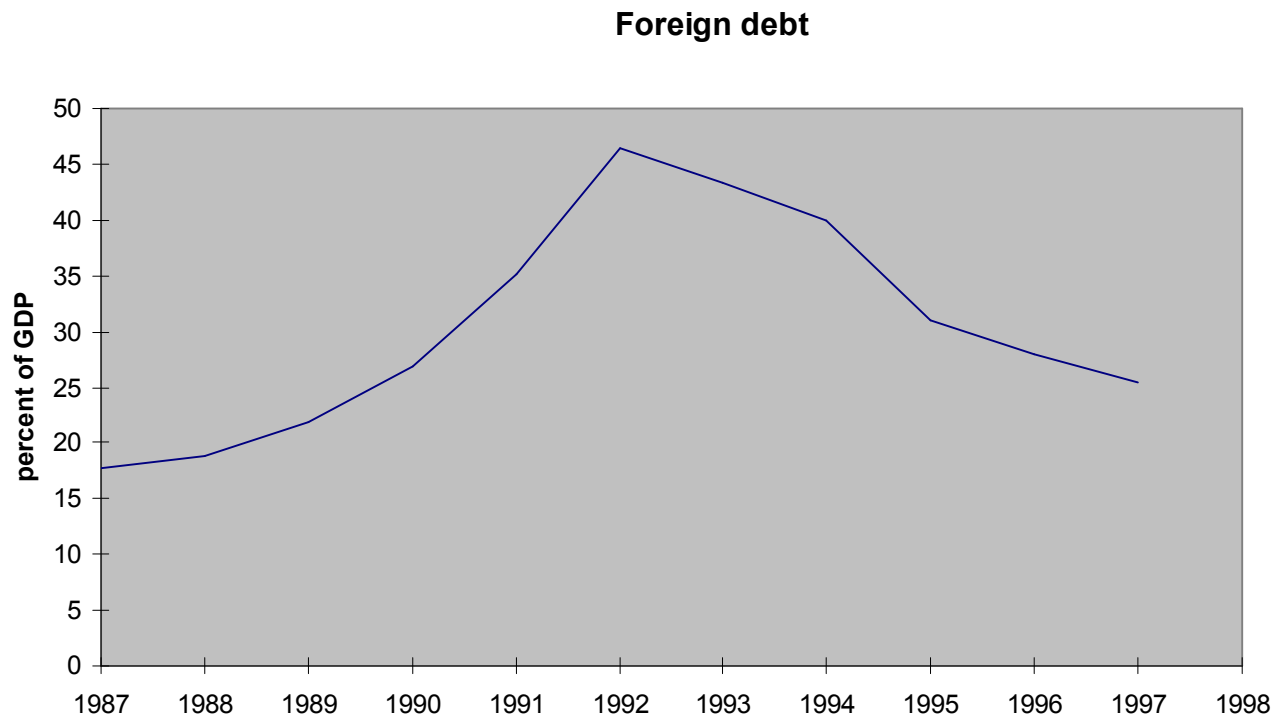
The latter half of the 1980s was characterized by:

- rapid growth of output, consumption and investment
- consumer price and asset price inflation
- widening current account deficit (to 5 % of GDP), increasing foreign debt but stable debt/GDP-ratio (25 %)
- full employment and good fiscal balance, very low public debt
- inflation & currency appreciation increased the Finnish price level in relative terms so that finally it was 40 percent higher than OECD average (in 1990)

Private sector debt was doubled within 4 years



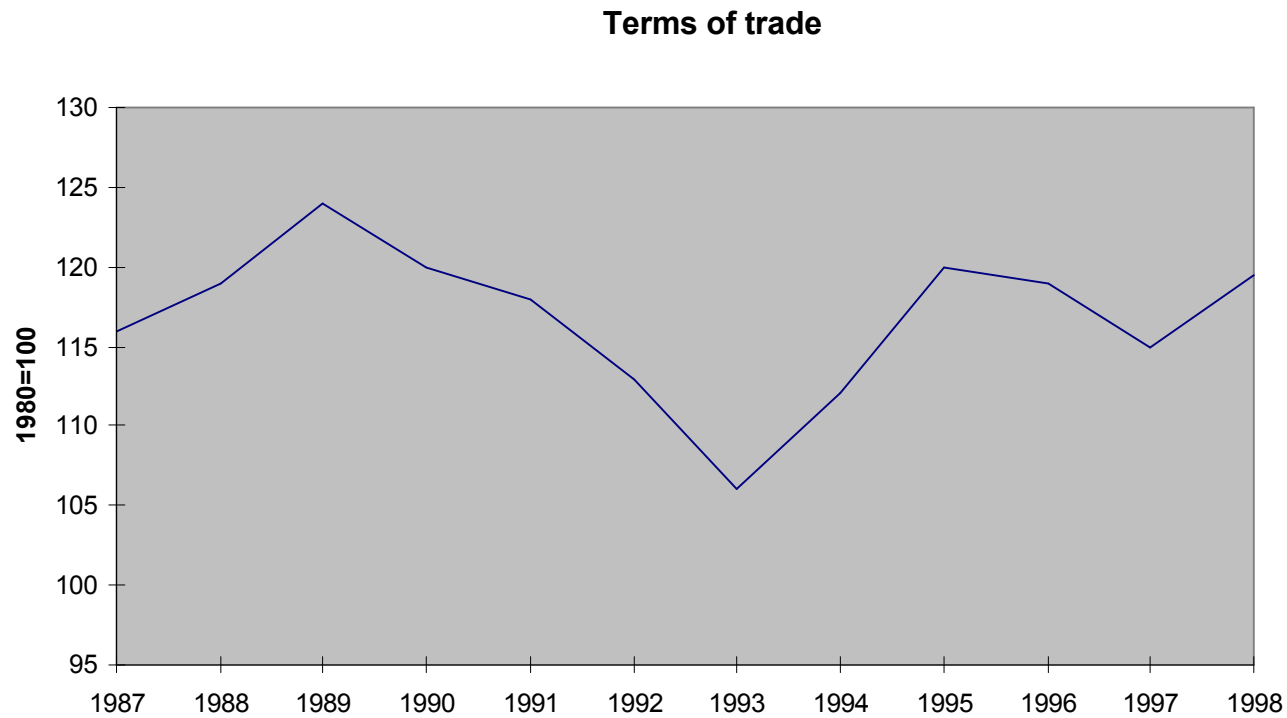
Foreign debt became a problem only after currency depreciation and output fall in 1991-93



Negative shocks changed the economic outlook in 1989-91

- Slowdown of international economy and rising European interest rates in 1990-93
- The collapse of Soviet Union and Finnish-Soviet trade in 1990-91: a negative export shock of 10 percent
- Decreasing terms of trade (due to declining export prices and rising oil price) together with appreciation of real exchange rate led to declining competitiveness and profitability

Cyclical variation of terms of trade

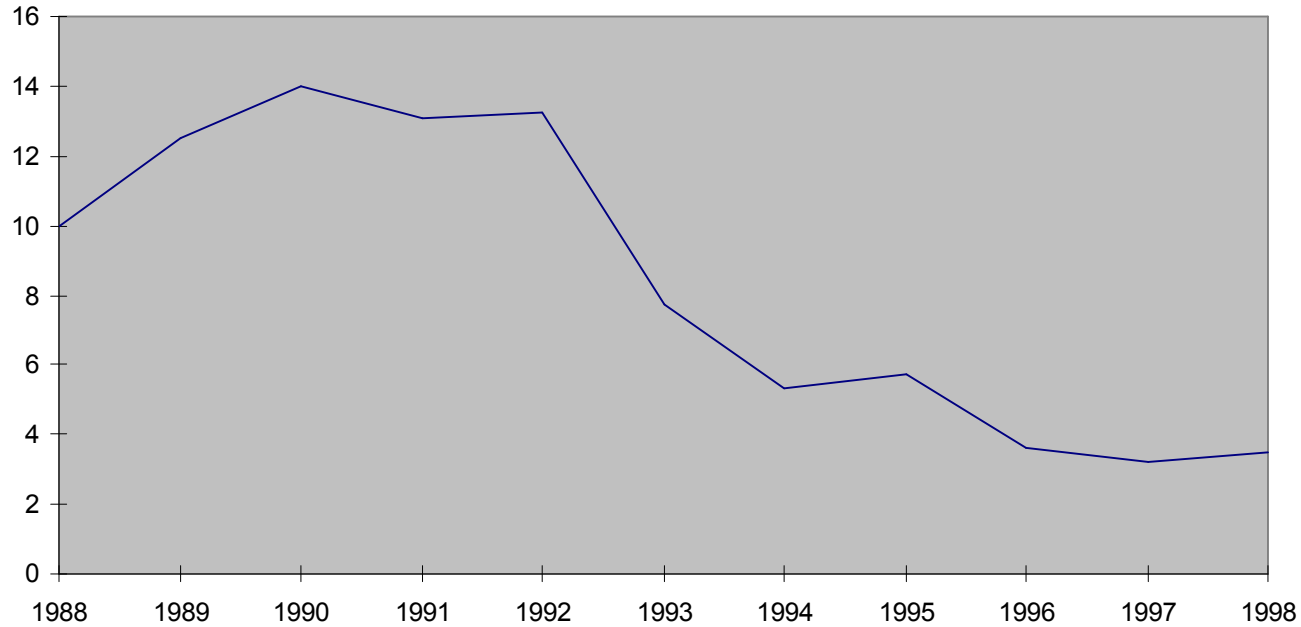


Strong currency became overvalued in 1989-91

- (foreign) investors and forex markets started to lose confidence in the stability of exchange rate
- As a result, waves of speculative attacks against the fixed exchange rate -> pressure on currency reserves
- Central bank's response: defend the exchange rate with high interest rates – on average 13 percent in 1989-1992
- Policy priority: in order to avoid devaluation a deflationary adjustment was chosen – depress demand and cut wages (=internal devaluation)

Period of high interest rates

3-month interbank rate



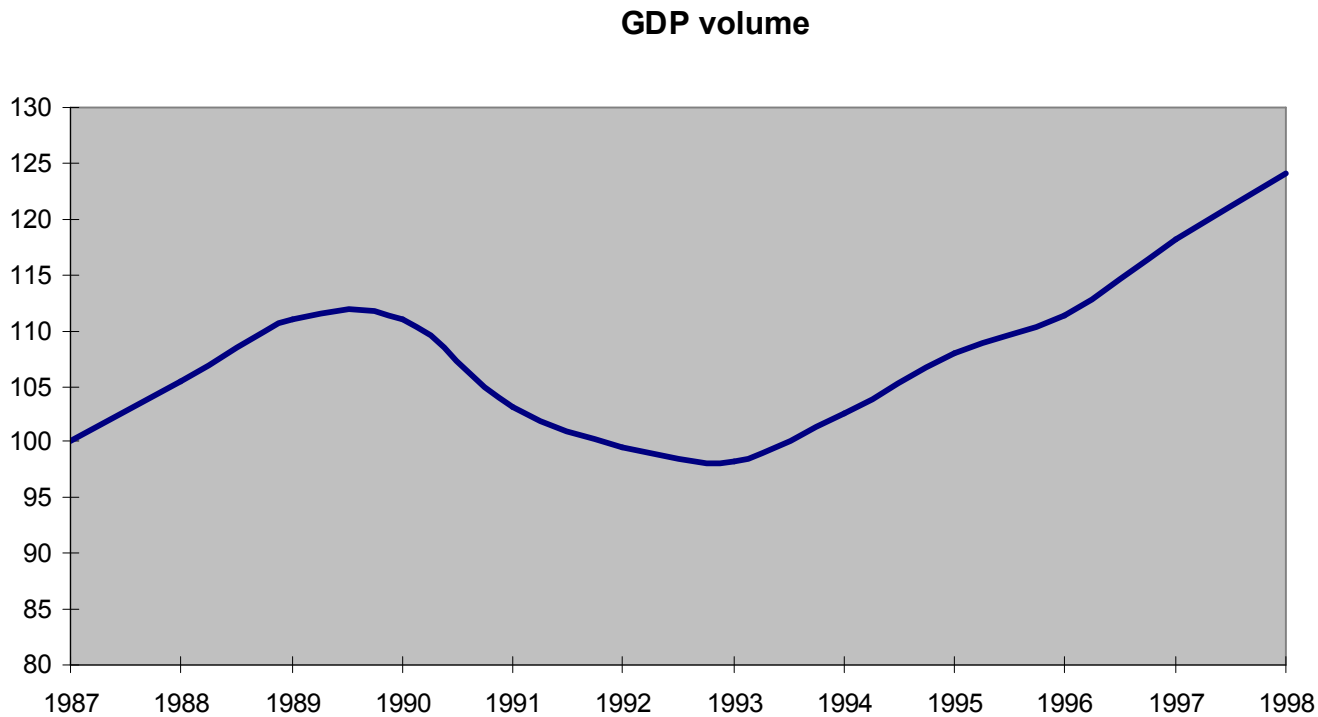
High real interest rates started a deflationary process

- private investment was reduced by 50 percent in 1990-1993
- private consumption was reduced by 10 percent in 1990-1993
- export earnings were reduced by 10 percent in 1991 – but exports recovered quickly in 1992
- stock market collapsed by 70 percent in 1989-1992 and house prices fell by 50 percent – enormous negative wealth effect
- GDP fell by 13 percent from mid 1990 to mid 1993 – mainly because of collapsing domestic demand (-20 %)

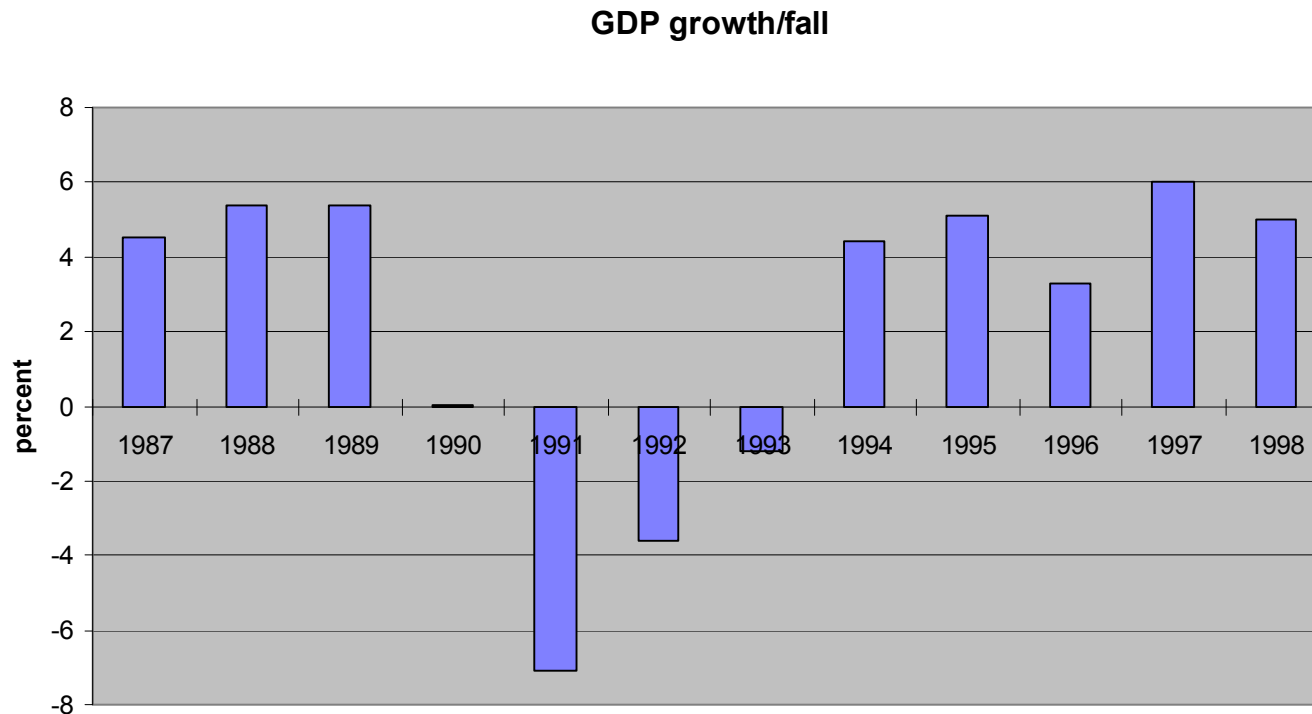
Balance sheet adjustment

- The main reason to the crisis was the need to readjust private sector balance sheets – to deleverage banks, firms, and indebted households
- This process was accelerated by high interest rates and shift in expectations (or 'animal spirits') from optimism to pessimism
- If all agents try to reduce indebtedness at the same time, a collapse in aggregate demand follows

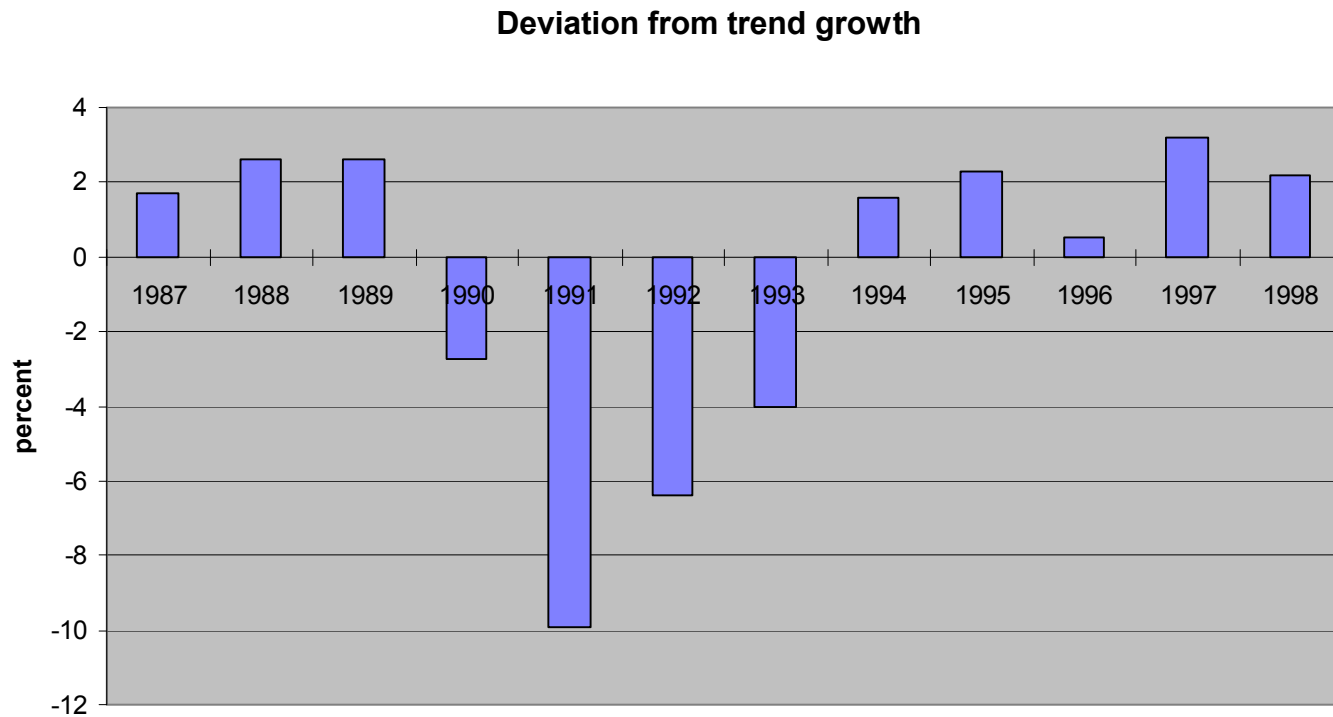
A 5 year slump in GDP volume



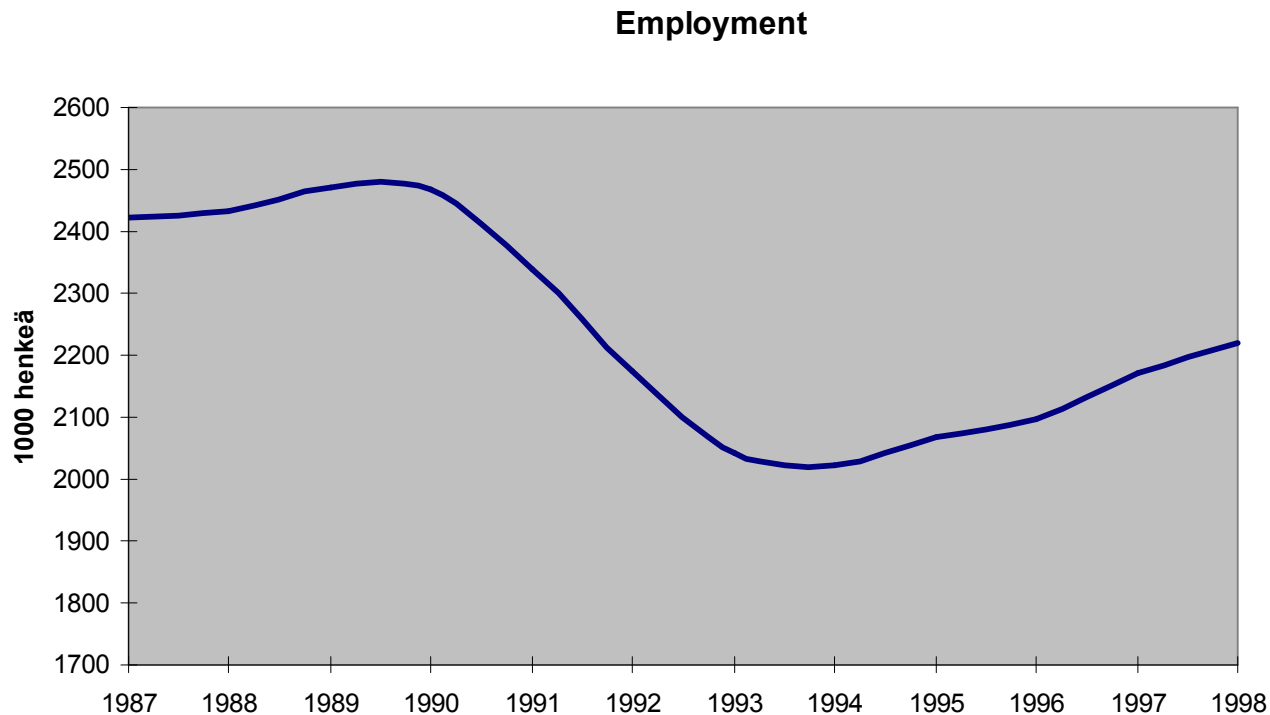
Four years without growth, three years with falling output



A 20 percent cumulative deviation from potential GDP



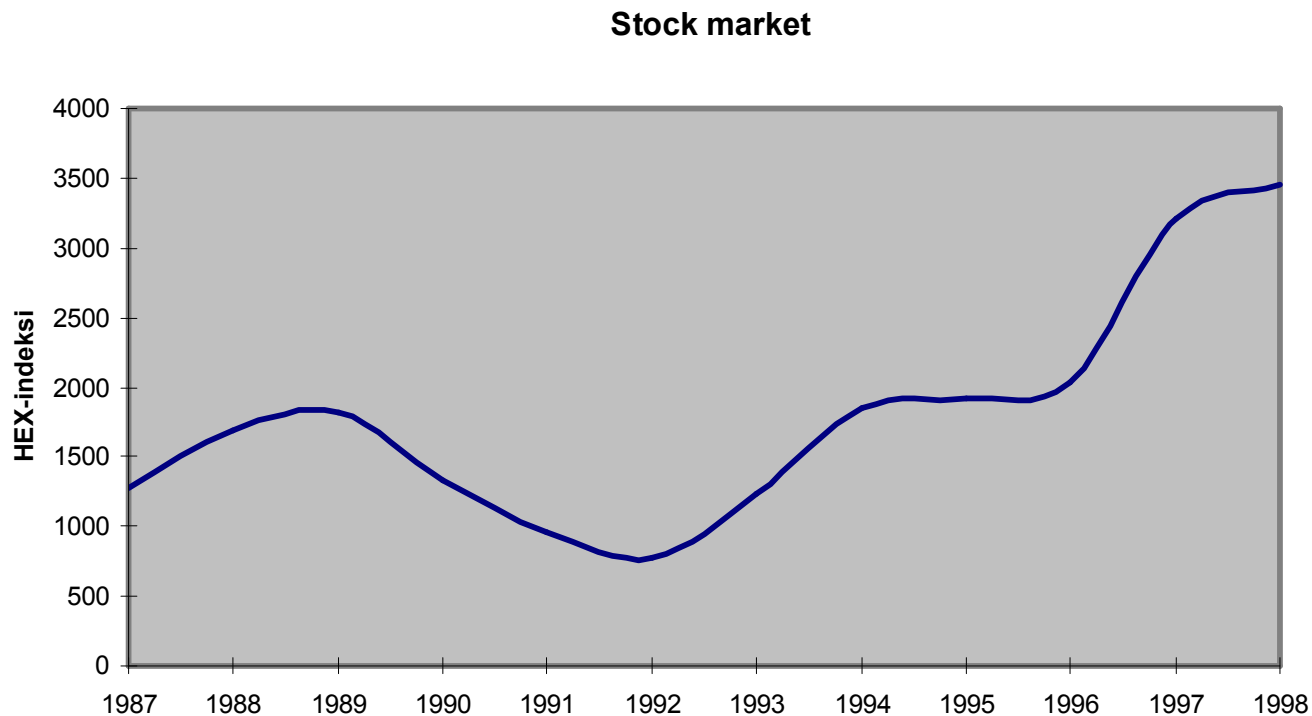
Employment was reduced by 20 percent (and 450 000 jobs lost)



Unemployment rate climbed from 3 to 18 percent within four years (total unemployment was even larger...)

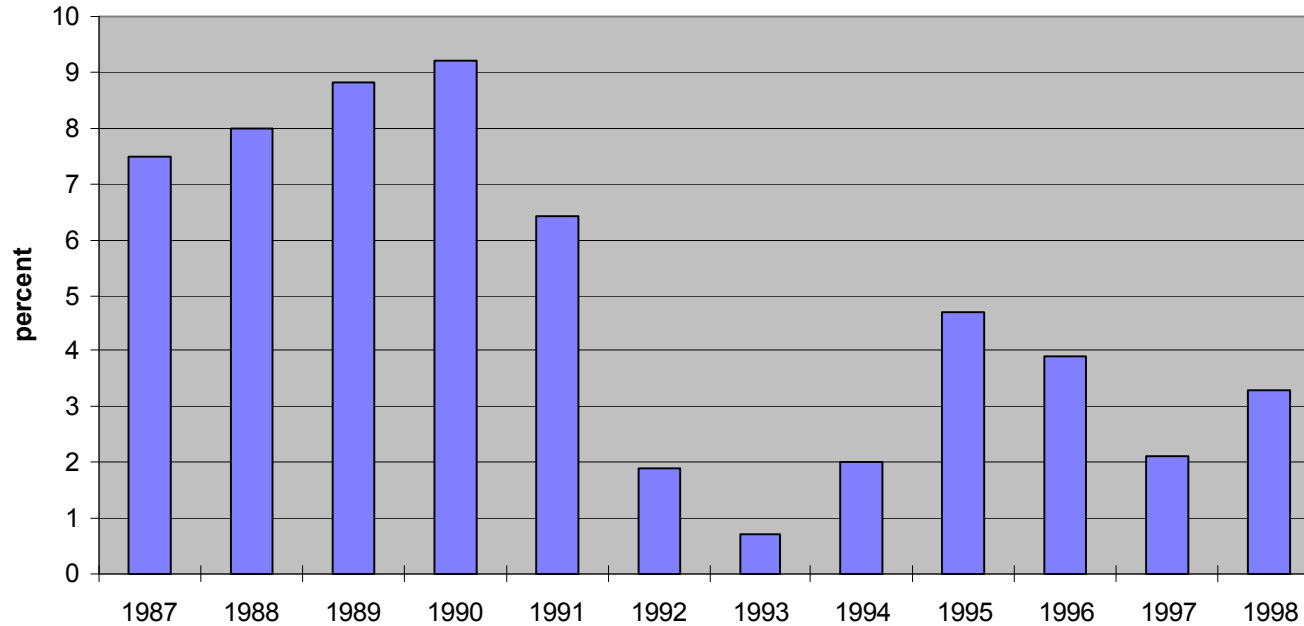


Stock market collapsed but recovered quickly – with the help of foreign investors



Wage moderation

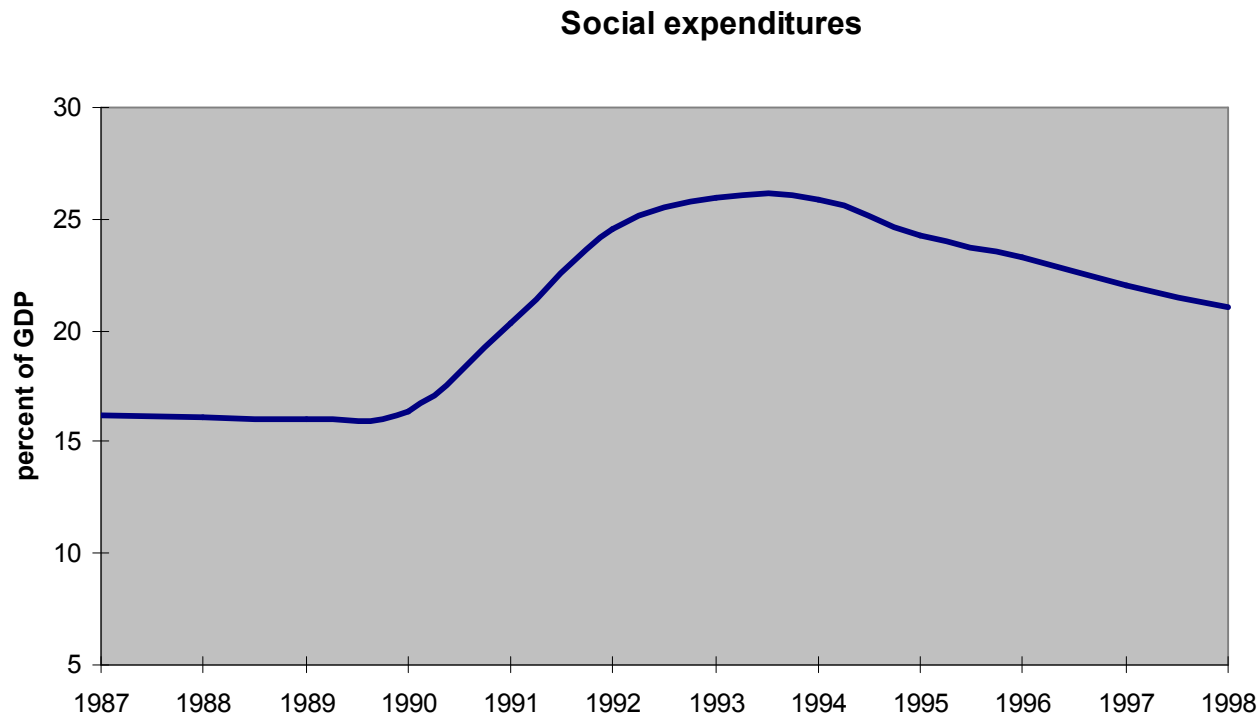
Nominal wage increases per annum



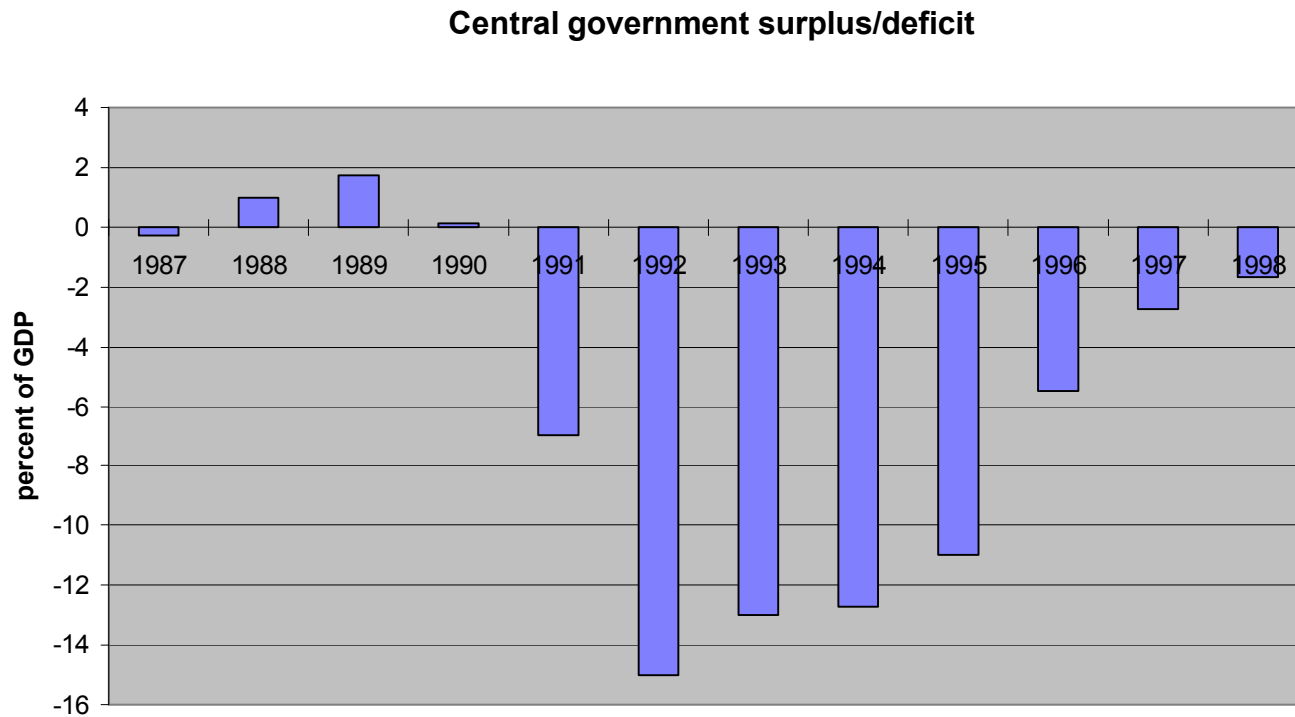
Social and economic disaster

- unemployment rose from 3 to 18 percent in 1990-1994
- permanent increases in long-term unemployment and poverty
- wave of bankruptcies, household debt problems
- public debt increased from 12 to 60 percent of GDP in 1990-1995
- cumulative credit losses of Finnish banks amounted to 15 percent of GDP

Sharp rise in social expenditures as a result of mass unemployment

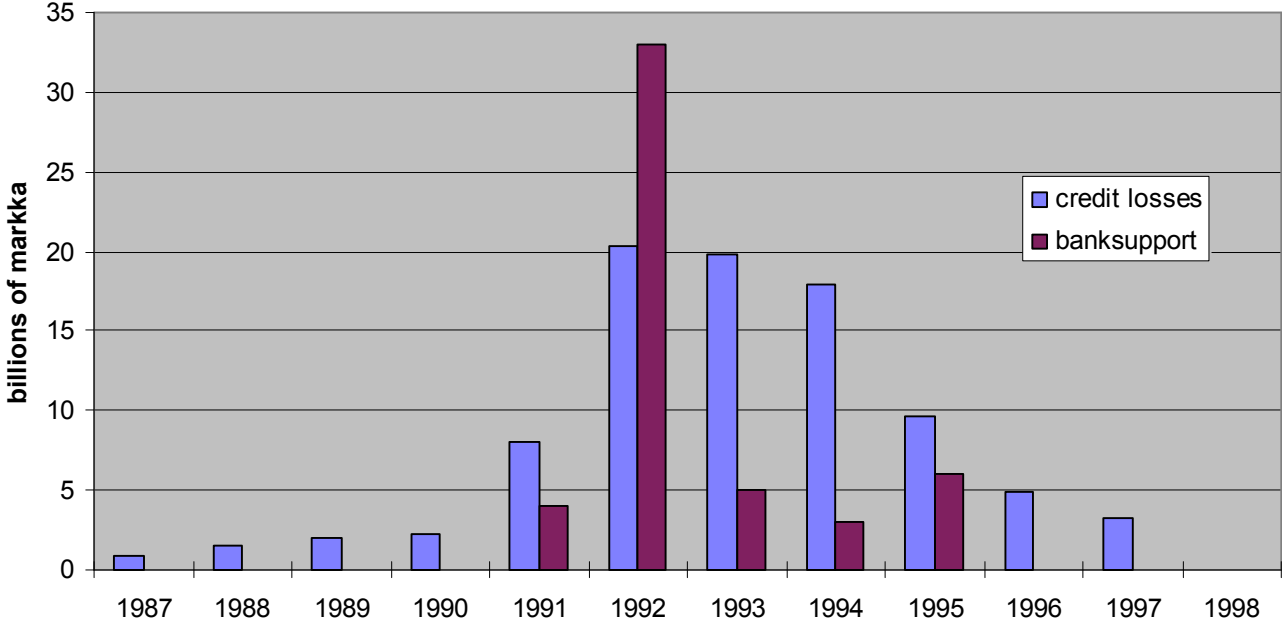


Central government finances got a serious hit

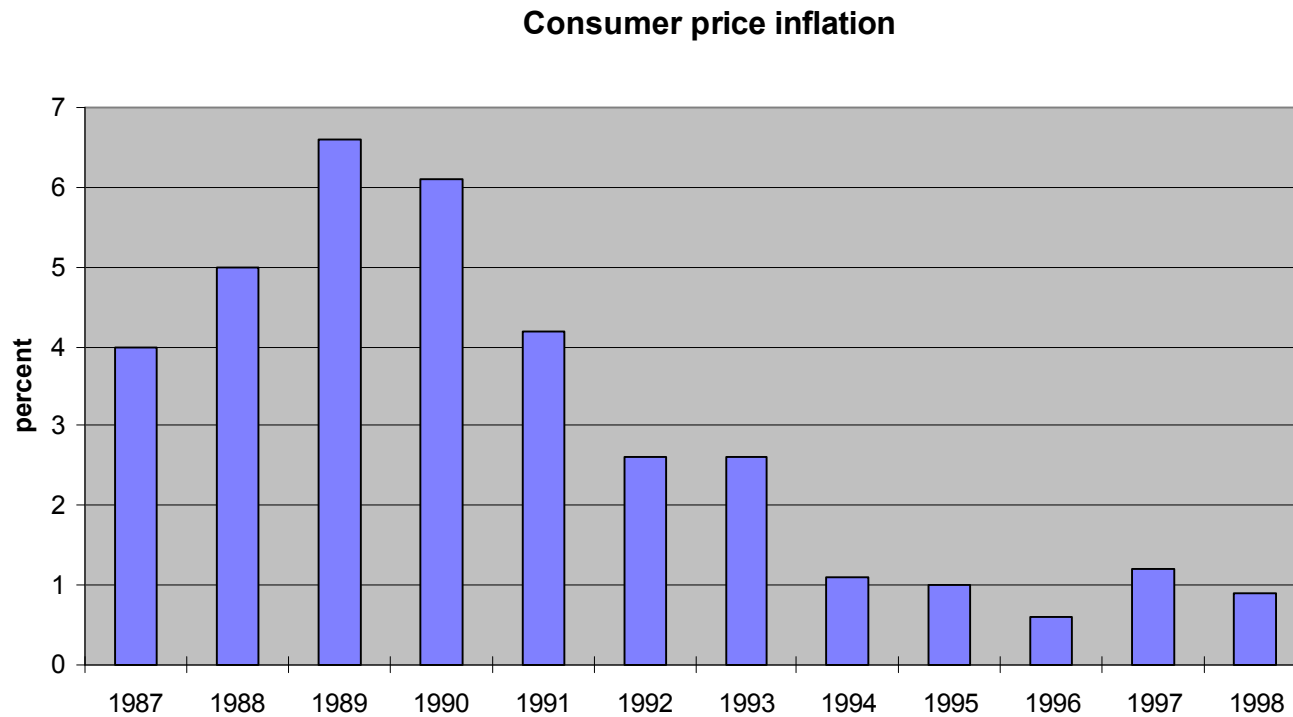


Credit losses were covered by public bank support

Credit losses and public bank support



Disinflation in spite of 30 percent currency depreciation



THE ROLE OF ECONOMIC POLICY

- Dogmatic reliance on fixed exchange rate policy against market sentiment and fundamentals
- Deflationary policy seen as the only viable option: high interest rates, shrinking aggregate demand – proposals to monetary/fiscal stimulus were rejected by g'ment & CB
- Decision makers: crime & punishment theory of crisis (cf. with the 1930s!)
- The consequences of such policies (=debt deflation) were not understood by policy makers, and they were surprised by the deepness of the crisis

FISCAL POLICY

- Fiscal policy was tightened in 1992-95
- Public demand (and employment) was reduced by 10 percent in 1992-93
- Social benefits were frozen or reduced
- Labour taxes were raised in 1992-95 by 8 % points (both income taxes and employers' contributions): as a result, the real after-tax incomes were reduced sharply
- In spite of these measures there were large deficits in 1992-94
- Fiscal policy was mostly pro-cyclical: tax cuts before and after the recession, tightening during the recession

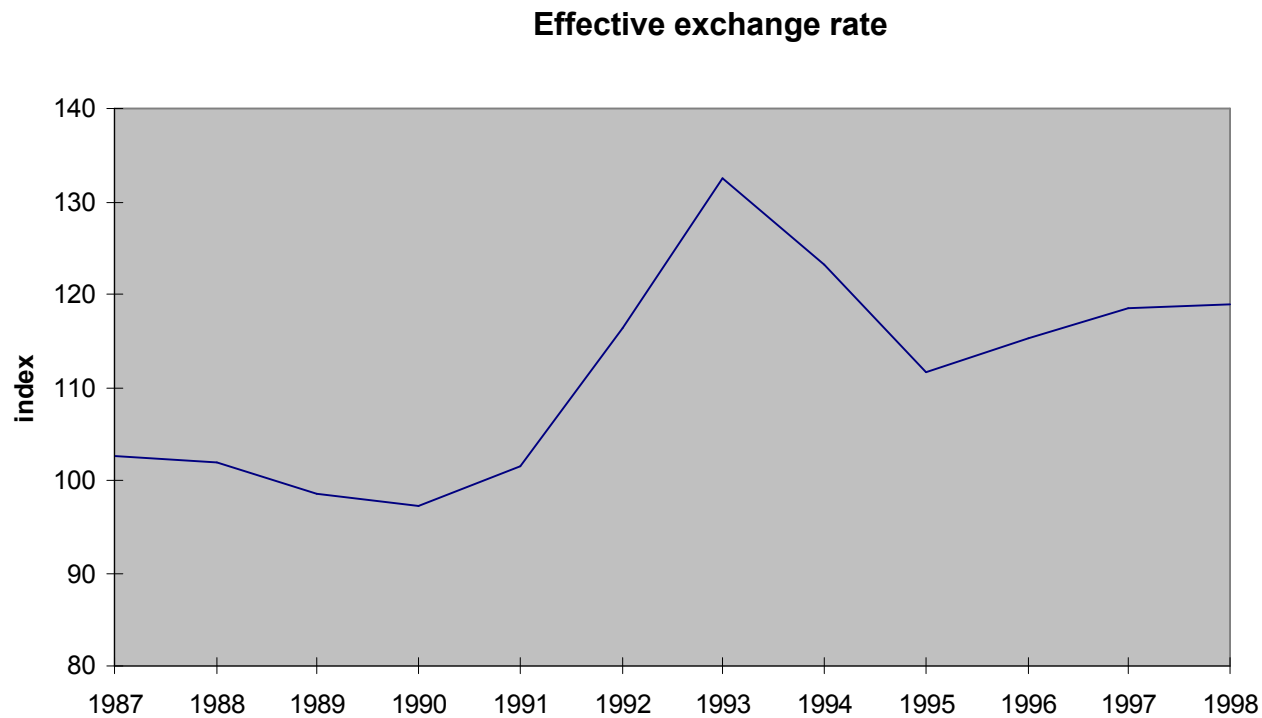
WHY THE DEPRESSION WAS SO DEEP ?

- Main reasons to the crisis were high interest rates caused by international factors and domestic monetary policy, and overindebtedness of Finnish corporate sector
- The macroeconomic consequences of falling asset prices were not understood properly by the policy makers: wealth effect and credit losses came as surprises
- Government's attempts to balance its budget by higher taxes and expenditure cuts backfired by further reducing private demand and employment

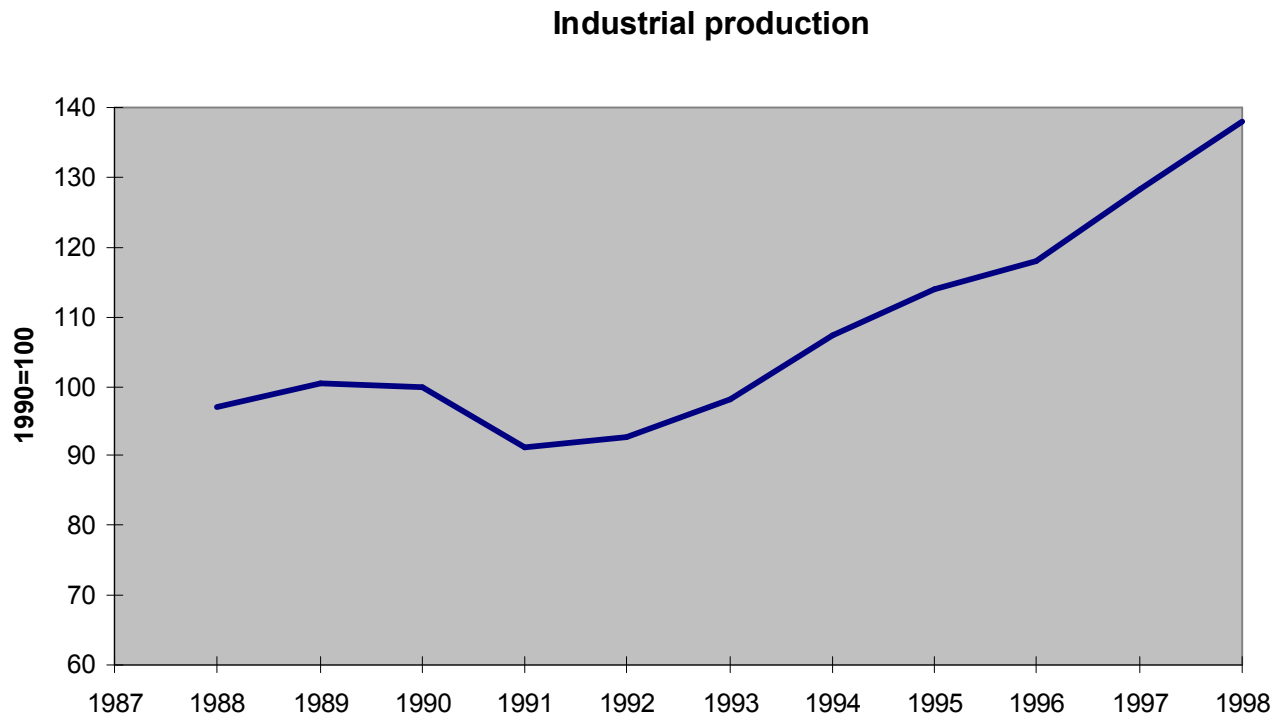
THE WAY OUT OF CRISIS

- The Bank of Finland was forced to abandon the policy of fixed exchange rate in September 1992 during the European currency crisis after losing its currency reserves and the Finnish markka was allowed to float
- the Finnish markka first depreciated by 40 percent, but started to appreciate later
- domestic interest rates were decreased rapidly from 15 to 5 percent

Currency depreciation was partly temporary and partly permanent



Industrial production benefited from devaluation and recovered rapidly



BANKING CRISIS

- Recession produced bankruptcies and credit losses, mostly from construction sector
- Largest losses in savings bank group, which had grown fastest and had highest appetite for risk (bad foreign investments financed by short term foreign currency borrowing)
- Other banks faced serious problems, too

SOLVING THE BANKING CRISIS

- Government take-over of the savings bank group:
 - dissolution and packaging of problem loans to a separate liquidation company ("Arsenal")
 - final cost 6 billion euros (7 % of 1994 GDP)
 - prosecution of failed bank managers: huge claims, long trials, few convictions
- Healthy parts of savings bank sold to other banks (=hidden subsidy?)
- Government's equity loans to all banks to recapitalize them

SOLVING THE BANKING CRISIS

- Restructuring and downsizing the banking industry:
 - Merger of two largest commercial banks (KOP + SYP = Merita)
 - Merger of biggest bank with a Swedish bank (Merita + Nordbanken = Nordea)
 - One third of bank staff laid off
- Banking crisis could have been insolvable without lower interest rates (=change in monetary policy); another year of recession would have exploded the credit losses
- Saving the banks was a policy priority, helping their customers was not discussed

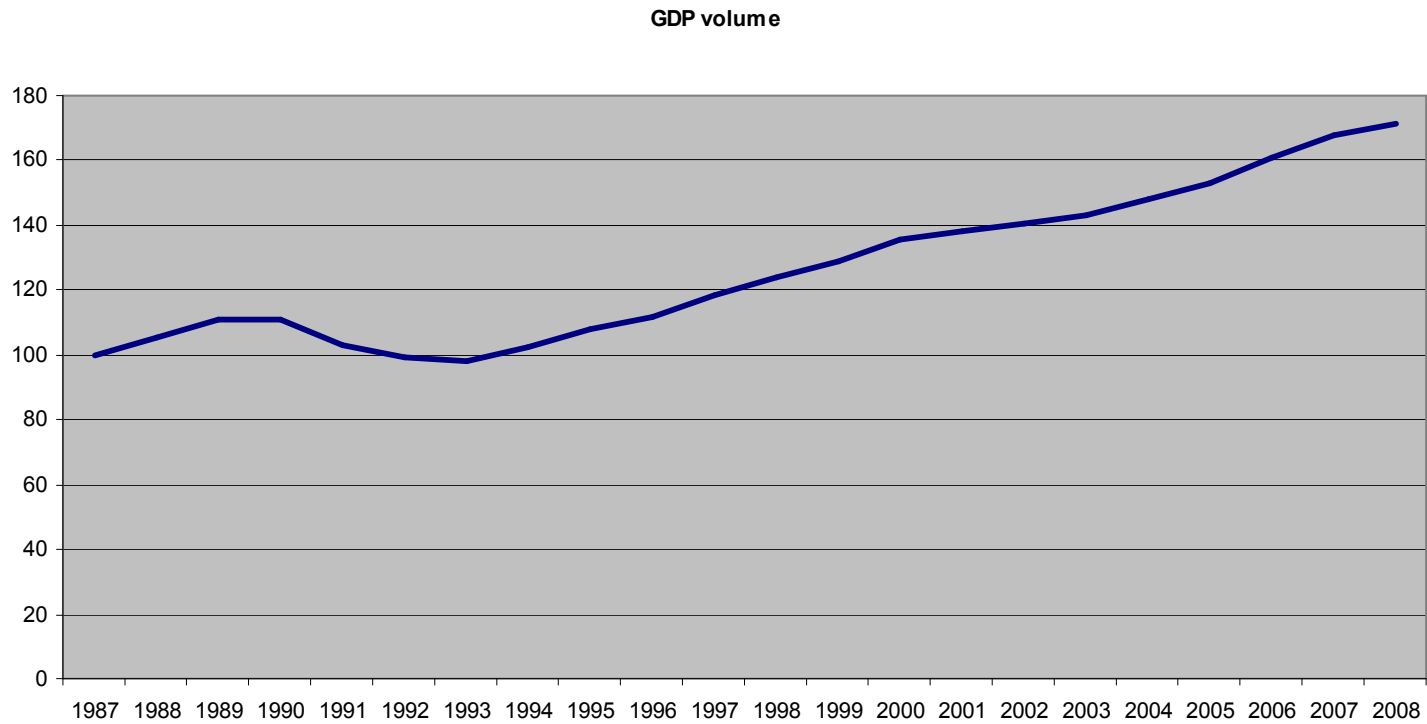
EXPORT GROWTH AND REFLATION

- Depreciation of the Finnish markka, productivity shift ('creative destruction') and wage moderation improved competitiveness hugely in 1992-94
- Strong growth of exports and industrial production started in 1992/1993 – but domestic demand lagged long behind
- Lower interest rates enabled lower savings and asset price reflation after 1994
- Consumer spending started to increase in 1994
- Investment ratio did not recover back to the pre-crisis level (= 25 % of GDP)
- Stock market revival: the HEX-index quadruppled in 1993-1998, dwarfing the pre-crisis 'bubble'

Very strong macroeconomic development after the crisis

- the average annual growth of GDP 4.7 percent in 1994-2000, 3.5 percent in 2001-2007
- unemployment decreased from 18 to 10 percent in 1994-2000 and to 6 percent in 2008
- fiscal consolidation and fulfilment of the EMU-criteria in 1997, record surpluses in 2000 and 2007: at the same time, tax cuts and steady growth of expenditures (=pro-cyclical policy fuelled the recovery)
- despite of significant currency depreciation inflation did not exceed European average (=unemployment above NAIRU)

GDP growth recovered to old trend



The social costs of the crisis were large and durable, and mostly related to long-term unemployment



REFLECTIONS ON THE CURRENT CRISIS

- Regular financial crises; necessary consequence of unregulated capital movements?
 - Finland & Sweden 1991-93
 - East Asian countries 1997-98
 - Mexico & Argentina
 - Great Crash of 2008
- Similar pattern of crises:
 - Deregulation -> optimism -> credit expansion -> overindebtedness & overvaluation -> panic -> depression
 - Fixed exchange rate has made foreign debt seemingly riskfree

REFLECTIONS ON THE CURRENT CRISIS

- In earlier cases the crises have been solved by currency depreciation
 - Export growth has solved the balance-of-payments problems
- What can be done within the Euro zone?
 - Deflationary policy looks like the only viable alternative
 - But adjustment is slow and painful